

Franked distributions and capital raisings

FSC Submission to Treasury

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1 About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advice licensees. Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing more than \$3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange, and is one of the largest pool of managed funds in the world.

The FSC's mission is to assist our members achieve the following outcomes for Australians:

- to increase their financial security and wellbeing;
- to protect their livelihoods;
- to provide them with a comfortable retirement;
- to champion integrity, ethics and social responsibility in financial services; and
- to advocate for financial literacy and inclusion.

2 Submission

The FSC thanks the Treasury for the opportunity to make a submission on draft legislation and explanatory materials released on 14 September 2020. The measure acts to prevent the franking of distributions to shareholders where the distribution is funded by particular capital raising activities.¹

¹ See: <https://treasury.gov.au/consultation/c2022-314358>

The FSC's comments on the proposal are outlined below.

This submission uses the terms **company** to mean the entities covered by the measure, namely companies, corporate limited partnerships, and public trading trusts.²

2.1 Retrospectivity

The FSC's main concern is with the retrospectivity of the measure.

The measure was first announced as part of the 2016-17 Mid-Year Economic and Fiscal Outlook, and the measure is set to commence from 19 December 2016. This means there will be a significant retrospective element to the legislation, amounting to almost six years, or more than 2,100 days as at the time of this submission. If the measure were to become law unamended, this would likely mean a retrospective element of more than six years (given the time it takes legislation to go through Parliament).

This raises a number of concerns for the FSC's members, particularly fund managers, superannuation funds and Investor Directed Portfolio Services (**IDPS**) platform administrators:

- All companies would face a risk of having historical distributions reviewed and amended by the ATO. This would create substantial and arguably unnecessary uncertainty in the market.
- A number of businesses undertook major capital raisings during COVID-19, in some cases due to a need to boost prudential or working capital. These capital raisings were atypical. Any franked distribution subsequent to these capital raisings might be at risk of being targeted by the measure, even when the original capital raising was supported by regulators.³
- If the measure applies to a historical distribution will the ATO require every investor at the time of distribution to amend their tax returns? If so how will this be implemented in practice for a widely held company, a company that has subsequently wound up, or for foreign shareholders?
- Fund managers, superannuation funds and IDPS platform administrators would face various problems if they or their investors own shares in a company that faces a retrospective amendment of an earlier distribution, including the following issues:
 - In some cases, there would be a need to amend numerous historical tax statements of investors in the relevant fund or company – in some cases this might affect millions of Australians. These individuals will need to re-lodge tax returns at considerable cost and inconvenience.

² See Exposure Draft EM at paragraph 1.4.

³ On 7 April 2020, APRA stated in a letter to banks that "Dividend payments should be offset to the extent possible through the use of dividend reinvestment plans and other capital management initiatives." – this statement, on the face of it, supports dividend payments funded by capital raisings. A similar sentiment was expressed in an APRA letter to banks of 29 July 2020.

- The relevant funds or administrators would face extensive critical feedback about poor member experience completely outside their control.
- A distribution to a non-resident would become subject to non-resident withholding tax. Managed funds would have under-withheld tax and the fund manager would have to wear the tax cost from a circumstance that was outside their control.
- In many other cases, the cost of the change will be paid by current members of a managed fund or superannuation fund, in which case there would be inequity between historical and current members of the relevant funds.⁴ Historical members would have received excessively high distributions, and current members would pay for this.
 - If the level of inequity were material, the relevant funds could face member legal action in response.

If the ATO is concerned about particularly problematic franking practices that have occurred since 2016, we submit that it would be more appropriate for these practices to be addressed through the existing anti avoidance rules.

The FSC **recommends** that the proposed measure, to the extent it is implemented, should only apply prospectively.

2.2 Other unenacted legislation

The measure is implementing an announcement made by the previous Government in 2016. The FSC submits that there are more important announcements that should be enacted as a higher priority than this measure.

Specifically, previous Governments have announced the following policies that to date remain unenacted, and these remain policy priorities:

- Introduce a comprehensive product modernisation (or product rationalisation) scheme for legacy products in financial services, made in 2015 in the then Government's response to the Financial Systems Inquiry (FSI).⁵
- Simplify the Taxation of Financial Arrangements (TOFA) rules, particularly relating to foreign exchange hedging, as announced by the previous Government in the 2016–17 Budget.⁶

⁴ For example, an Attribution Managed Investment Trust (AMIT) might use 'unders and overs' to deal with the change in the franking of a previous distribution.

⁵ See inquiry recommendation 43 – legacy products, and the Government's response outlined here - <https://www.treasury.gov.au/publication/government-response-to-the-financial-system-inquiry/attachment-government-response-to-financial-system-inquiry-recommendations>

⁶ See 2016–17 Budget Paper 2, pages 37–38.

- Implement an alternate measures to support financial services industry once the Offshore Banking Unit (OBU) regime ends, as announced by the previous Government on 12 March 2021.⁷
- Address the issues with tax residency for companies (announced in the 2020–21 Budget) and consult on extending this measure to other entities (announced in the 2021–22 Budget).⁸
- Address issues with the Investment Manager Regime (IMR) which are undermining its effectiveness, as announced by the previous Government in July 2017.⁹

These measures would remove unjustified tax imposts on investors that will result in higher savings, higher productivity for financial services and reduced costs for the Government in the long term (due to reduced spending on the Age Pension).

More details on these unenacted measures are contained in previous FSC Pre-Budget submissions.¹⁰

The FSC **recommends** that the Government should place a higher priority on implementing other unenacted measures that are long-standing policy recommendations of the FSC.

2.3 Promoting certainty

The measure will potentially apply to many capital distributions – as a result, there could be a large number of requests for tax rulings from companies. These ruling requests could come at substantial costs to companies and the ATO – with the costs on the ATO ultimately borne by the Budget. In fact, if there is a large enough increase in ruling requests, then the measure could have a net cost to the Budget.

Therefore, if the measure is implemented, we submit that the ATO should make a commitment to a simple and speedy approach for tax rulings relating to the proposal so that companies and investors can have tax certainty. Otherwise it is likely that either:

- Companies, the ATO and (ultimately) taxpayers will incur high costs and resources from the large number of ruling requests; or
- Companies will avoid obtaining rulings which will place the entities and their investors at risk of the measure applying to distributions after they have occurred.

The FSC submits that neither of the alternatives above are appropriate.

⁷ See: <https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/amending-australias-offshore-banking-unit-regime-0>

⁸ See 2021-22 Budget factsheet “Tax incentives to support the recovery”, page 8.

⁹ See: <http://kmo.ministers.treasury.gov.au/media-release/064-2017/>

¹⁰ See in particular the FSC Pre-Budget submission for 2022–23, available from: <https://fsc.org.au/resources/2135-fsc-submission-federal-budget-2021-22/file> and the FSC Pre-Budget submission for 2019–20, available from: <https://fsc.org.au/resources/1717-2019-20-budget-fsc-submission-combined/file>

The FSC **recommends** that the ATO implement a simpler and speedy approach to facilitate companies obtaining a tax ruling in relation to the measure.

2.4 Scope of proposed measure

The FSC has concerns that the proposed measure is very broad and has potential to affect numerous capital distributions. For example some concerns with the measure include:

- The proposed measure presumes that companies have regular and pre-determined distribution policies. However, this largely does not occur in practice – the widespread change in distribution practices during COVID-19 being a case in point.
- The measure covers equity issues that occur before, during or after the distribution (EM at 1.26). This is, on the face of it, unnecessarily broad.
- The measure could apply to a company that has substantial retained profits and wishes to make a franked distribution, but has recently made large investments. As the company no longer has free cashflow to fund dividends, it decides to raise capital to fund dividends and as a consequence falls within the scope of the proposed measure (EM at 1.30).
- The measure applies if one amongst many purposes of the capital raising is to fund a distribution, as long as the purpose is not an ‘incidental’ purpose (EM at 1.33).
- The measure could apply to a company that has volatile profits, cashflow or where there is no ‘established practice’ in relation to its distribution policy (EM at 1.18).
- The measure applies to an entire distribution even if the tests are only satisfied in relation to part of the distribution (EM at 1.27).
- The measure may result in a chilling effect on capital raisings more generally, particularly for companies with irregular dividend policies. As a result corporate leverage may increase, in turn increasing systemic financial risks.

The FSC **recommends** the measure should be more narrowly targeted at clearer cases where true avoidance of tax is involved.